

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
STRATHMORE BAGELS, INC.	:	
for Redetermination of a Deficiency or for	:	
Refund of Corporation Franchise Tax under	:	
Article 9-A of the Tax Law for the Years 1984	:	
and 1985.	:	

In the Matter of the Petition	:	
of	:	
STRATHMORE STABLES, INC.	:	
for Redetermination of a Deficiency or for	:	
Refund of Corporation Franchise Tax under	:	
Article 9-A of the Tax Law for the Years 1981	:	
through 1985.	:	

	:	DETERMINATION
	:	DTA NOS. 809142
	:	AND 809143

Petitioner Strathmore Bagels, Inc., 4064 Nesconset Highway, East Setauket, New York 11733, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the years 1984 and 1985.

Petitioner Strathmore Stables, Inc., c/o Jerry Steuerman, 23 Empress Pines Drive, Lake Ronkonkoma, New York 11779, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the years 1981 through 1985.

On or about February 9, 1993 and February 23, 1993, respectively, petitioner by Jerry Steuerman and the Division of Taxation by William F. Collins, Esq. (Vera Johnson, Esq., of counsel) consented to have the petition of Strathmore Bagels, Inc. determined on submission without a hearing. On or about February 9, 1993 and April 16, 1993, respectively, petitioner by Jerry Steuerman and the Division of Taxation by William F. Collins, Esq. (Vera Johnson, Esq., of counsel) consented to have the petition of Strathmore Stables, Inc. determined on submission

without hearing. All documentary evidence and briefs were due by June 16, 1993. The Division of Taxation submitted documentary evidence on April 16, 1993. Neither party has submitted a brief.¹ After due consideration of the record, Marilyn Mann Faulkner, Administrative Law Judge, renders the following determination.

ISSUES

I. Whether petitioner Strathmore Bagels, Inc. proved entitlement to certain deductions as ordinary and necessary business expenses.

II. Whether petitioner Strathmore Stables, Inc. was the nontaxable corporate-agent for its taxable principal, the sole officer and shareholder.

FINDINGS OF FACT

Strathmore Bagels, Inc.

Petitioner Strathmore Bagels, Inc. was a corporation engaged in the business of wholesaling and retailing bagels in the metropolitan commuter transportation district.

Petitioner Strathmore Bagels, Inc. filed its 1984 and 1985 metropolitan transportation business tax surcharge reports (CT-3M/4M) and its 1984 and 1985 corporation franchise tax reports on March 18, 1985 and

March 17, 1986, respectively. Jerry Steuerman signed, as president of petitioner, a consent extending the period of limitation of the assessment of taxes for the audited period until April 15, 1989.

The Division of Taxation ("Division") conducted a franchise tax audit of petitioner's 1984 and 1985 corporation franchise tax reports and metropolitan transportation business tax surcharge reports.

By letter dated January 28, 1987, the auditor requested petitioner's books and records for

¹Both petitions were signed by petitioners' representative, Kenneth B. Schwartz, Esq. A power of attorney appointing Mr. Schwartz as representative was attached to each petition. In the power of attorney Jerry Steuerman was identified as the president of both Strathmore Bagels, Inc. and Strathmore Stables, Inc.

1984 and 1985. In response, petitioner Strathmore Bagels, Inc. provided a general ledger, Federal returns and some expense documentation but was unable to provide documentation substantiating the following business expenses that were claimed as deductions on the 1984 and 1985 corporation franchise tax reports:

	<u>1984</u>	<u>1985</u>
automobile expenses	\$ 6,614.00	\$ 3,455.00
equipment rental expenses	18,242.00	2,190.00
insurance expense	<u>6,913.00</u>	<u>6,409.00</u>
TOTAL	\$ 31,769.00	\$ 12,054.00

The Division disallowed the above expenses because they were not substantiated but only to the extent of 50% because it attributed the disallowed portion of the reported expenses to the personal use of petitioner's sole stockholder and officer. The Division also disallowed, as unsubstantiated, a \$1,599.00 auto depreciation expense for the year 1985. Accordingly, the Division calculated the total franchise tax liability for 1984 and 1985 as \$2,126.40 and 1,780.40, respectively, and subtracted the tax reported for those years (\$538.00 for 1984 and \$250.00 for 1985) in determining franchise tax due in the amount of \$1,588.40 for 1984 and \$1,530.40 for 1985. Based on the disallowed expenses, the Division calculated a surcharge tax liability of \$361.49 for 1984 and \$302.67 for 1985 and subtracted petitioner's reported surcharge tax deficiency (\$91.00 for 1984 and \$43.00 for 1985) to arrive at a surcharge deficiency of \$270.49 for 1984 and \$259.67 for 1985.

The Division issued to petitioner Strathmore Bagels, Inc. four notices of deficiency, dated January 23, 1989, as follows:

<u>Notice Number</u>	<u>Period</u>	<u>Type of Tax</u>	<u>Amount</u>
C890123775F	1984	corporation franchise tax	\$1,588.40
C890123776S	1984	surcharge	270.49
C890123777F	1985	corporation franchise tax	1,530.40
C890123778S	1985	surcharge	259.67

These notices also included penalties and interest in addition to the above-stated amounts.

A conciliation conference was held on August 8, 1990. By Conciliation Order dated November 23, 1990, the conferee sustained the four statutory notices.

Petitioner Strathmore Bagels, Inc. filed a petition, dated January 18, 1990, claiming that

the Division erred by improperly denying deductions for an automobile expense, equipment rental, insurance premiums and automobile depreciation. Petitioner alleged that all of those deductions consisted of items that were paid or incurred by it as ordinary and necessary expenses of its trade or business and, thus, qualify as deductions under sections 162 and 168 of the Internal Revenue Code of 1954, as amended.

The Division filed an answer, dated March 6, 1991, affirmatively stating, inter alia, that petitioner has the burden of proving that deficiencies are erroneous pursuant to Tax Law § 1089(e).

Strathmore Stables, Inc.

Petitioner Strathmore Stables, Inc. is a New York corporation which was incorporated on September 21, 1981 and was owned by shareholders Jerry and Elaine Steuerman. Strathmore Stables, Inc.'s principal business activity was horse racing.

The Division conducted a personal income tax audit of petitioner's shareholders, Jerry and Elaine Steuerman, in which the Division disallowed Schedule C losses reported by the Steuermans on their personal income tax returns. The Division disallowed a reported net loss of \$78,768.00 for 1984 and a net loss of \$107,764.00 for 1985 because the business activity resulting in the losses was petitioner's business activity. The Steuermans had not filed a petition for Subchapter S treatment.

According to an affidavit by the Division's auditor, Lawrence Wolff, petitioner Strathmore Stables, Inc. not only filed a certificate of incorporation on September 21, 1981, it also conducted business as a corporation, maintained corporate checking accounts, and received income and incurred debt in its own name.

As a result of the Steuerman audit, the Division commenced an audit of petitioner Strathmore Stables, Inc. and discovered that petitioner never filed a corporation franchise tax return or surcharge report for the years 1981 through 1985. The Division computed petitioner's corporation tax liability for 1984 and 1985 by utilizing the amounts reported in the Steuermans' Schedule C which reflected gross receipts of \$136,299.00 in 1984 and \$136,173.00 for 1985.

To these amounts, the Division added additional receipts of \$42,986.00 for 1984 and \$239,039.00 for 1985 based on its analysis of petitioner's cash payouts and bank deposits. From the total receipts for 1984 and 1985, the Division subtracted the cost of goods sold and other expenses for the respective years. Also, for 1984 the Division subtracted the supplemental loss reported by the Steuermans as reflected in their 1984 Schedule C and added supplemental gain reported on their 1985 Schedule C. The Division calculated that petitioner Strathmore Stables should have reported income in the amount of \$58,882.00 for 1984 and \$138,625.00 for 1985. Based on this income, the Division determined a minimum corporate tax due of \$250.00 for 1981 through 1984 and \$13,625.00 for 1985.

The Division also used its estimation of income to calculate Metropolitan Transportation Business Tax ("MTBT") surcharge for the years 1982 through 1985. Because the MTBT surcharge was not effective in 1981, the Division did not assess a surcharge for 1981.

The Division issued to petitioner Strathmore Stables, Inc., nine notices of deficiency, dated May 2, 1989, as follows:

<u>Notice Number</u>	<u>Period</u>	<u>Type of Tax</u>	<u>Amount</u>
C890502775F	12/31/81	corporation franchise tax	\$ 250.00
C890502776F	12/31/82	corporation franchise tax	250.00
C890520777S	12/31/82	surcharge	45.00
C890520778F	12/31/83	corporation franchise tax	250.00
C890520779S	12/31/83	surcharge	43.00
C890520780F	12/31/84	corporation franchise tax	250.00
C890520781S	12/31/84	surcharge	42.50
C890502782F	12/31/85	corporation franchise tax	13,862.50
C890502783S	12/31/85	surcharge	2,356.63

The nine notices also contained additional amounts for penalties and interest.

A conciliation conference was held on August 8, 1990. The conferee, by Conciliation Order dated October 26, 1990, sustained the nine statutory notices.

By petition dated January 18, 1991, petitioner challenged the nine statutory notices of deficiency. In this petition, petitioner Strathmore Stables, Inc. contended that the Division erred in issuing the notices based on the following allegations:

"The Commissioner has erred by incorrectly assigning to the taxpayer, income and expenses properly attributable to the taxpayer's sole officer and

shareholder under Section 61 regulations thereunder, and applicable case law (see eg., Comm. v. Bollinger, Jr., et al., 88-1 USTC 9233). Specifically, the Commissioner has refused to recognize the taxpayer's status as agent rather than principal with respect to all transactions alleged against it for the ownership and maintenance of race horses."

The Division filed an answer dated March 15, 1991 stating, inter alia, that the Division estimated petitioner's franchise tax liability pursuant to Tax Law § 1081(a) based on records made available by petitioner such as purchase invoices, expense documentation and checking account; and that pursuant to Tax Law § 1089(e), petitioner has the burden of proving that the Division's estimations are erroneous.

CONCLUSIONS OF LAW

Strathmore Bagels, Inc.

A. Tax Law § 209 imposes on every domestic or foreign corporation a franchise tax on its entire net income for the privilege of doing business in this state in a corporate or organized capacity. Tax Law § 208.9 defines "entire net income" as the:

"total net income from all sources, which shall be presumably the same as the entire taxable income (but not alternative minimum taxable income), (i) which the taxpayer is required to report to the United States treasury department"

Under the Internal Revenue Code ("IRC") § 63, "taxable income" means gross income minus deductions. IRC § 162(a) allows as a deduction "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."

B. Inasmuch as the parties did not submit briefs, it is unclear from the record whether the Division denied the deductions claimed because petitioner did not substantiate whether the alleged expenses were "paid or incurred during the taxable year" or paid or incurred as ordinary and necessary business expenses. Because the Division disallowed only 50% of the deductions on the ground that the disallowed portion related to the personal use of the automobile and rental equipment by petitioner's sole stockholder and officer, it is assumed that the controversy rests on petitioner's failure to substantiate that the deductions related to ordinary and necessary business expenses. In any event, the record does not indicate that petitioner provided any substantiation to support either the amount of the deduction or entitlement to the deductions as

ordinary and necessary business expenses.

Petitioner has the burden of proving entitlement to the deductions claimed (see, Tax Law § 1089[e]). Inasmuch as no evidence has been introduced to substantiate petitioner's allegation in its petition that the deductions related to ordinary and necessary business expenses, it has not carried its burden of establishing entitlement to the deductions (see, Matter of Fazal Ahmad, P.C., Tax Appeals Tribunal, August 8, 1991; cf., Matter of Coleman, Tax Appeals Tribunal, May 18, 1989 [in personal income tax cases, taxpayer granted allocation of automobile expenses as business deduction based on record evidence]).

Strathmore Stables, Inc.

C. When a corporation's income is not accurately reflected in its books and records, the Division may use an indirect method, "cash availability" analysis, to determine deficiencies in the corporation franchise tax (see, Matter of R & J Automotive, Tax Appeals Tribunal, June 15, 1989; Matter of Cousin Service Station, Tax Appeals Tribunal, August 11, 1988). In such cases, the taxpayer has the burden of proving by clear and convincing evidence that the method used to arrive at the franchise tax deficiencies is erroneous.

Here, petitioner does not challenge the Division's audit methodology. Relying on Commissioner v. Bollinger (485 US 340, 99 L Ed 2d 357), petitioner argues that it is a nontaxable agent of its principal, the sole officer and shareholder, and that, therefore, income and expenses are attributable to the principal only.

In Commissioner v. Bollinger (supra), the United States Supreme Court held that a corporation was a nontaxable agent for the principals who were taxable shareholders. In finding the corporation to be a nontaxable agent, the Court applied the standard set forth in its prior decision, National Carbide Corp. v. Commr. (336 US 422, 93 L Ed 779, 69 S Ct 726). In National Carbide, the Court asserted four indicia and two requirements of the corporate-agent status. These indicia and requirements became known as the six National Carbide factors and were set forth by the Bollinger court as follows:

"[1] Whether the corporation operates in the name and for the account of the principal, [2] binds the principal by its actions, [3] transmits money received to the

principal, and [4] whether receipt of income is attributable to the services of employees of the principal and to assets belonging to the principal and to assets belonging to the principal are some of the relevant considerations in determining whether a true agency exists. [5] If the corporation is a true agent, its relations with its principal must not be dependent upon the fact that it is owned by the principal, if such is the case. [6] Its business purpose must be the carrying on of the normal duties of an agent" (Commr. v. Bollinger, supra at 346-347, quoting National Carbide Corp. v. Commr., supra at 437).

The decision in Bollinger focused on the meaning of National Carbide's fifth factor. The Bollinger Court held that the fifth factor requires unequivocal evidence of the genuineness of the agency relationship in order to prevent tax-avoiding manipulations. In Bollinger, the Court found such evidence in (1) a written agreement, which was made at the time the income-producing asset was acquired and which stated that the corporation functioned as an agent and not a principal with respect to the asset for all purposes, and (2) on the fact that the corporation was held out as the agent and not the principal in all dealings with third parties relating to the asset.

In the present case, petitioner submitted no evidence to support the genuineness of the agency relationship. The only information in the record concerning the relationship is the affidavit of Lawrence Wolff, the Division's auditor who conducted petitioner's audit. In that affidavit, he noted that petitioner was incorporated on September 21, 1981; that it owned a franchise; that it maintained corporate checking accounts, received income in its own name and incurred debt in its own name; that the Schedule C losses reported by the Steuermans were the losses from petitioner's business activity; and that the Steuermans did not file an election for Subchapter S treatment.² Petitioner does not contest the facts as alleged by the Division's auditor. Thus, in the circumstances of this case and absent evidence in support of petitioner's allegation that it acted as the agent for the stockholder, petitioner has not carried its burden of proving that the Division's audit results were erroneous.

D. The petition of Strathmore Bagels, Inc. is denied and the four notices of deficiency

²In 1981, subdivision 9 of section 209 of the New York State Tax Law was added to exempt a corporation from franchise tax if it elected to be an S corporation pursuant to Tax Law § 660 (L 1981, ch 103, § 26).

dated January 23, 1989, are sustained.

E. The petition of Strathmore Stables, Inc. is denied and the nine notices of deficiency, dated May 2, 1989, are sustained.

DATED: Troy, New York
November 10, 1993

/s/ Marilyn Mann Faulkner
ADMINISTRATIVE LAW JUDGE